



Prospering in Constrained Economic Times

Executive Summary

Corporate profit margins are at their highest levels in 60 years. By several measures, corporate America is the healthiest it has been in decades, with trillions in cash reserves. So as an equity investor, should you be worried? Absolutely.

Cost-Side Profit Gains Reaching Their “Half Life”

Since the recession began in 2008, businesses have successfully restructured and streamlined operations, taking significant expense out of their organizations to stabilize and grow profits in the context of a constrained economy. As a result, corporations as a whole have emerged from the recession with far more efficient, leaner operations. Many of these businesses have achieved record profitability and balance sheet strength using ‘profit preservation’ strategies (Figure 1). However, those that have relied heavily on expense-side performance gains may have ultimately compromised their long-term competitiveness.

Given the dramatic cuts corporate America has made, businesses have now reached a point of diminishing returns on their cost containment and expense reduction programs. In fact, continuing

to pursue this course carries significant risk. In numerous examples of businesses that reach for profits by cutting costs, such as Sara Lee and the Tribune Company, reliance on cost cutting left these organizations weakened and susceptible to market share losses to competitors who employed a more thoughtful long-term, organic growth strategy.

GIVEN THE DRAMATIC CUTS CORPORATE AMERICA HAS MADE, BUSINESSES HAVE NOW REACHED A POINT OF DIMINISHING RETURNS ON THEIR COST CONTAINMENT AND EXPENSE REDUCTION PROGRAMS.

It will become increasingly more difficult to invest and follow through on cost-side profit gain strategies. Moreover, waiting for the ‘old normal’ of a robust economy is not a winning strategy considering that magnitude of growth is likely several years away.

What should you expect of future economic growth? In this report, MainStream Management identifies the key macroeconomic trends that will impact business performance over the next five years:

- Continued deleveraging of consumers and corporations, and the future deleveraging of the public sector
- Unsustainably high corporate profit margins
- Low levels of saving, spending and income growth on the consumer level
- Ongoing recessionary pressures resulting from government (in) action

Each of these factors individually would compromise the long-term viability of corporations pursuing ‘save your way to success’ programs. Taken together, the sustainable way to create business value in this ‘perfect storm’ is to deploy a strategic process for organic growth.

Corporate Profits are at an Unsustainable All-Time High

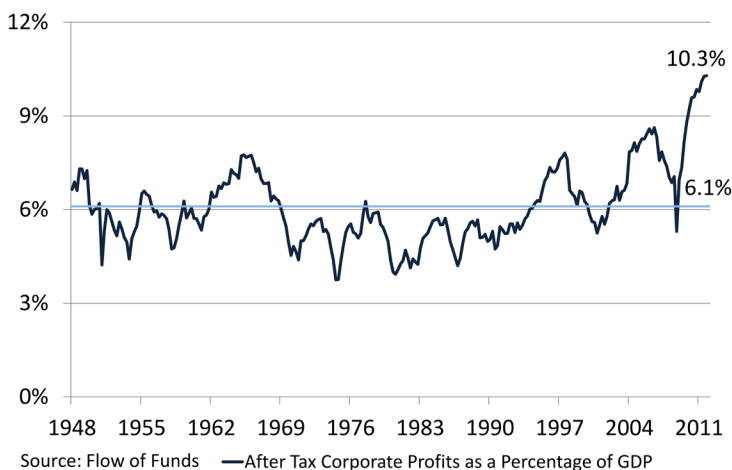


Figure 1. After tax corporate profits as a percentage of GDP.

A Stagnating Economy

An Era of Deleveraging

Economic collapses and 'big bang' economic events have traditionally been synonymous with deleveraging—the process of reducing debt in relation to income or gross domestic product (GDP). The financial crisis of 2007 was this type of an event for the U.S. Signs point to the typical outcome of such a crisis: an extended era of deleveraging with anemic growth as the economy struggles under the burden of a several decade-long build-up of consumer, public, and private sector debt (Figure 2).

So far, U.S. deleveraging has followed this pattern. A financial crisis in an overleveraged economy often causes a slowdown in debt accumulation at some levels of the economy, while others continue to leverage. This is ultimately followed by an economy-wide decrease in debt in relation to GDP—a cycle that takes five to seven years to complete, but can take longer if deleveraging is delayed. The beginning of deleveraging is typically characterized by a recession, occurring shortly after a financial crisis, followed by an extended period of erratic, below average economic growth that only ends when the economy resumes debt accumulation.

REGARDLESS OF HOW THE U.S. PROCEEDS, THE RESULTS OF DELEVERAGING ARE SIMILAR AND INEVITABLE: REDUCED ECONOMIC GROWTH FOR AN EXTENDED PERIOD.

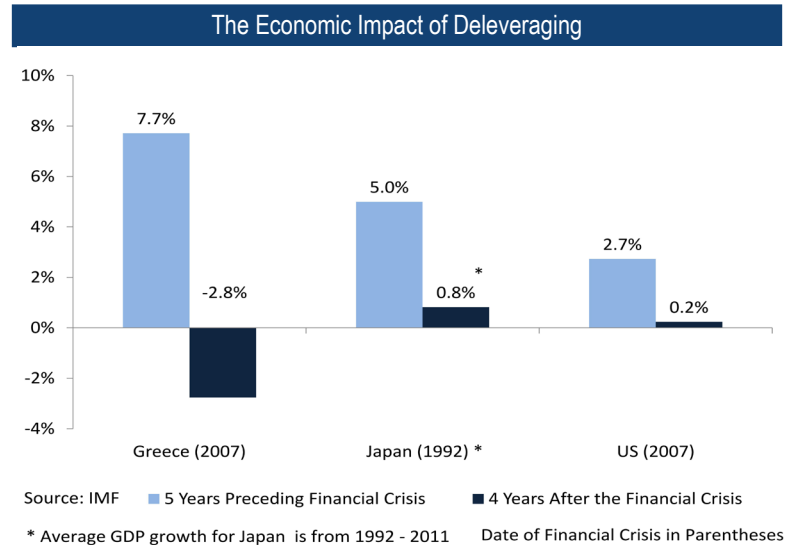


Figure 3. Real GDP growth pre and post financial crisis.

The immediate reaction to a financial crisis can take various paths (Figure 3) but it ultimately leads to either deleveraging (as is currently taking place in Greece) or the delay of deleveraging (often through government intervention, which we are seeing in Japan). Regardless of how the U.S. proceeds, the results of deleveraging are similar and inevitable: reduced economic growth for an extended period.

In the U.S., consumers and financial institutions were the first to deleverage, mostly through defaults on mortgage debt and revolving credit. Non-financial corporations soon followed as asset prices fell and the recession intensified. Meanwhile, the government increased leverage in an attempt to counteract the recession and private sector deleveraging. Yet, despite four years of debt reduction, the private sector remains highly leveraged while the government has yet to start deleveraging. As a result the U.S. is experiencing its weakest economic recovery since the Great Depression. This will likely continue for the next five years—a Great Stagnation.

This means corporations are not out of the woods, and more so, difficult times lie ahead for the average corporate investor due to the following factors:

1. *Consumer spending is pressured.* Without accumulating more debt, consumers have to rely on savings and organic income growth, both of which are at historically low levels, to fuel the consumption that drives corporate revenues.

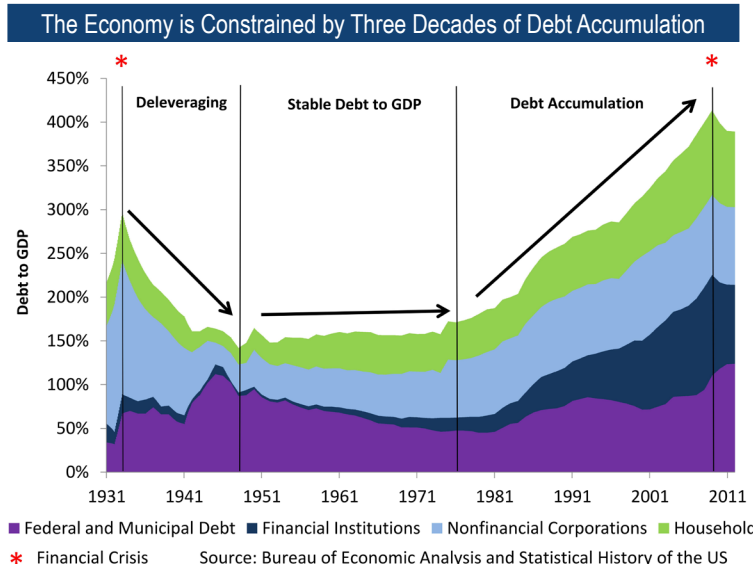


Figure 2. Total debt to GDP.

2. *Recessions during deleveraging periods cause a unique set of obstacles for corporations.* The lower productivity and difficult decision making for a seemingly bleak future lead managers to scale back operations (which we have seen over the last three years) in a way that negatively affects long-term growth capabilities.
3. *Deleveraging dampens valuations.* Investors pay less for assets that produce the same cash flow because they have less confidence that earnings will be sustained, let alone grow. This and the lack of debt in financing transactions (another symptom of deleveraging) causes lower valuations and lower returns for investors looking to monetize their portfolio.

Record Margins

Unsustainable Corporate Profits

Despite an anemic economic recovery, U.S. corporations generated more than \$1.5 trillion in profits (after tax) in 2011. This is more than 36% higher than the prerecession record of \$1.1 trillion in 2006, and double the low experienced in 2008, despite real GDP growth of only 4.2%. This was largely due to cost containment, decreased savings on the household level, and massive amounts of direct and indirect government assistance.

Corporate investors need to recognize that as these same factors normalize, they will exert downward pressure on corporate profitability as labor costs increase, productivity growth and consumer spending slows, and government debt and tax policy remain a giant potential headwind.

Over the last three years, cost containment measures taken by corporations have allowed revenue growth to exceed costs. Volume and prices increased modestly, while unit labor costs have grown much more slowly dropping to all-time lows as a percentage of GDP, resulting in record corporate profit margins (Figure 4). Employers have lowered labor costs by carrying fewer employees, being more selective in hiring staff as part-time and/or at lower starting wages, and increasing wages at a slower rate than overall inflation.

Pressured Consumers

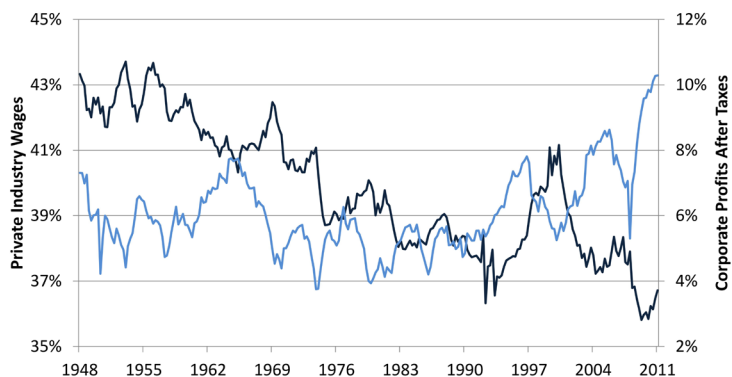
While employers benefited, consumer income growth was limited to a mere 0.6% over the last 12 months. Without earned income gains, consumers have drawn down their savings to support spending. Household savings decreased by one-third (\$231 billion) since peaking in 2010, dropping the savings rate to 3.8%, the third lowest level since 2009. As a result, both income growth and consumption growth are at levels not seen except in an economy going into, or recently emerging from, a recession.

BOTH INCOME GROWTH AND CONSUMPTION GROWTH ARE AT LEVELS NOT SEEN EXCEPT IN AN ECONOMY GOING INTO, OR RECENTLY EMERGING FROM, A RECESSION.

Domestic consumption accounts for 70% of GDP and 80% of corporate profits, a slight reduction in consumption will have a significant impact on both. As an example, a one percent decrease in consumption would reduce GDP by \$100 billion, which is slightly smaller than the entire increase in corporate profits in 2011.

MainStream believes that corporations waiting for consumption growth will likely have to wait much longer than anticipated. With little income growth, little savings and no desire or ability to take on more debt, the consumption of corporate goods and services will likely slow in the immediate future.

Employers Have Cut Labor Costs to All-Time Lows to Increase Margins



Source: Bureau of Economic Analysis, Flow of Funds — Private Industry Wages — After Tax Corporate Profits

Figure 4. Private wages and profits as a percentage of GDP.

Government Policy Risks

Corporations have benefited from the direct and indirect assistance provided by the U.S. government since the last recession. The federal government has increased spending to combat the deleveraging occurring in the private sector while trying to promote increased private spending. Tax initiatives such as lowering income and payroll taxes, and various rebates, such as the ones targeting the housing and auto industries, have proven ineffective in stimulating sustainable demand. Quantitative Easing, the Federal Reserve's purchase of mortgage and government debt, has lowered interest rates on all types and durations of debt. This has reduced lending costs for corporations and consumers alike, causing an increase in the value of assets (equity and commodities) that have been purchased as a result.

address the symptoms of deleveraging, low consumption and high unemployment, ignore their root cause. The U.S. is experiencing economic difficulty due to a reversal of decades of debt build-up. In a deleveraging environment, lowering interest rates and increasing unproductive government spending does little to promote the sustainable long-term growth that consumers and corporations need. MainStream believes the U.S. government should shift its focus from promoting debt accumulation to promoting the growth and stability required for corporate growth.

REDUCING MARGINS TO THEIR LONG-TERM AVERAGE OF 6.1% WOULD BY ITSELF LOWER CORPORATE PROFITS BY OVER 40% IN THE ABSENCE OF GROWTH.

The greatest indirect benefit of government spending on corporations has come from the transfer payments made to consumers that have been used to buying products and services from U.S. businesses. Government transfer payments (i.e. welfare, social security and public employee wages) accounted for 23% of all income earned in 2011.

At issue is that government spending, which has supported corporate profit growth, will soon come to an abrupt halt without concerted political action. Over two dozen tax provisions are set to expire at the end of 2012, which according to the Congressional Budget Office will amount to an increased tax burden of \$5.4 trillion over the next decade. This, in addition to government spending cuts mandated by the debt Super Committee, will result in a net decrease in GDP of 4% in 2013, which would push an already weak deleveraging economy into another recession.

These are the realities that the U.S. government, operating in an overleveraged economy, must face. Delaying deleveraging has its own set of consequences; however, this is the path that fiscal and monetary policy makers have taken. The government's attempts to

A Strategy for Growth

Responding to the Challenge of a Constrained Economy

Corporations are at a precarious crossroad. On the one hand they have shored up their balance sheets following three years of cost cutting, with record profit margins and liquid assets in the trillions to show for it. Alternatively, their reluctance to invest in the future growth necessary to drive value creation in times of an economic slowdown has compromised asset valuations.

MainStream projects that margins will revert over time to the long-term average of 6.1% of GDP from their current peak levels of +10%. Reducing margins to their long-term average of 6.1% would by itself lower corporate profits by over 40% in the absence of growth. Combining this with private sector deleveraging, reduced consumer savings, and the uncertainty related to government spending clearly indicates that businesses must focus on organic growth in order to maintain asset values and, ultimately, deliver meaningful financial return.

The Process of Growth

Growth is a structured, strategic process that is both unique and interconnected across all facets of a company's operations. MainStream identifies four essentials for management to pursue in order to deliver above trend-line performance:

1. *Business Focus:* Sharply focusing on the core competencies of a business creates a firm connection between the organization and its customers. By evaluating competitive market position and spinning off any peripherals that are not primary to customer needs, distractions are eliminated and strategic priorities are effectively understood throughout the organization.
2. *Speed of Execution:* The rate of business change occurs at an exponential rate. Technology, product life cycles, and consumer preferences are all moving at a pace that requires speed and agility of execution. Anything less will be a failure to maintain market position. Accelerating the execution of a strategic plan requires a shift in thinking that treats program implementation as a change initiative.
3. *Customer Alignment and Sales Force Effectiveness:* No matter how great a product may be, if it is misaligned to the market and the competencies of the sales force to sell it, its full potential will never be achieved. Organizing and segmenting the business around the customer is a foundational step toward achieving sustained growth so that customers are served by the right people with the right products. Comprehensive evaluation of the buying behavior and demographics within the customer portfolio, and of the skill sets of the sales organization, will ensure necessary adjustments can be made to align with changing customer requirements.
4. *Pricing Management:* When a one-cent swing in pricing can change company profits by hundreds of thousands and even millions of dollars, the results can be incredibly rewarding, or simply devastating. Yet studies have shown that the majority of CEOs rarely engage in detailed discussions on pricing and most organizations lack an understanding of what the customer is willing to pay. Even in a constrained economy, opportunities exist to increase price and in such a way that creates advantage for the business and value for the customer.

Organizational strength is derived from focus allowing innovation to occur within a plan of prioritized growth that enables the greatest return on product investments and marketing effectiveness. The net result: a business centered on what it does best and one that has the freedom to excel in doing what matters most.

About MainStream Management

MainStream can help by taking a holistic view of your business performance from bottom-line financial management to top-line value creation. We deliver results that have consistently surpassed expectations. Our operational expertise in revenue and strategy formulation in addition to corporate restructuring and bankruptcy dispositions support the long-term asset values and strategic growth of our clients.

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